California Public Employees' Retirement System
Investment Office
P.O. Box 2749
Sacramento, CA 95812-2749
TTY: (916) 795-3240
(916) 795-3400 phone
www.calpers.ca.gov

Agenda Item 8a(2)

August 15, 2011

TO: MEMBERS OF THE INVESTMENT COMMITTEE

I. SUBJECT: Absolute Return Strategies (ARS) Program – ARS Allocation

II. PROGRAM: Asset Allocation / Risk Management

III. RECOMMENDATION: Information

IV. ANALYSIS:

The ARS program allocation originated as part of Global Equity (GE) in 2002, but was not included in the policy benchmark at that time. Hence, it was an active allocation relative to the policy benchmark. In February 2010, the ARS allocation was included in the GE benchmark with a composite ratio of 95% GE benchmark and 5% ARS benchmark, effectively reducing the equity exposure in the GE policy benchmark. Since the inclusion of ARS in the GE benchmark through June 30, 2011, the ARS benchmark return has trailed the GE benchmark by more than 10% annualized. Since inception, the return and risk of ARS and GE benchmarks have been at variance. This is to be expected as the ARS benchmark is cash +5% while GE is a market return.

During the 2010 Asset Liability Management review, staff discussed the role of asset classes in the strategic policy portfolio and concluded that ARS is an active investment strategy and not a strategic asset class since ARS has limited market (beta) exposure. All of the asset classes in the policy portfolio have a strategic role and exposure to macro risk factors (growth, inflation, interest rates) while ARS does not. Accordingly, ARS was not included in the asset allocation strategic policy mix approved by the Committee.

Staff is recommending to the Policy Subcommittee in August 2011 that the ARS allocation be managed as an active allocation separate from the strategic policy benchmark. This active allocation will be managed within an active risk (tracking error) budget and framework. The allocation limit is established by the lower of two measures:

1. 4% of the Total Fund allocation, or
2. Tracking error contribution of 40 basis points to the Total Fund implementation risk.

The current allocation (Table 1) to ARS is 2.2% and the contribution to tracking error is 23 basis points.

Table 1

CURRENT ASSET ALLOCATION
as of July 25

Asset Class	Policy Target	Actual	Active Weight
Public Equity (GE)	49.0%	49.6%	+0.6
Private Equity (AIM)	14.0	13.9	-0.1
Income (GFI)	18.0	17.5	-0.5
Real Assets	12.0	9.0	-2.8
Inflation Assets	3.0	3.1	+0.1
Liquidity	4.0	4.7	+0.7
Program			
ARS	--	2.2	+2.2
Opportunistic	--	--	--
TOTAL	100.0%	100.0%	0.0

In this framework, staff will assess the over and underweights of all policy asset classes making up the Total Fund policy benchmark as well as allocations to active strategies. Staff will also consider the respective contributions to tracking error of each asset class and active strategy. This approach recognizes that the ARS allocation may not originate from a fixed source, such as GE, as in the past, but could come from a mix of the liquid asset classes (GE, GFI and Liquidity).

This approach is similar to the Opportunistic program approved by the Committee with a maximum allocation of 3% of Total Fund which is not included in the policy benchmark. Currently, the actual allocation to Opportunistic is zero.

Risk unit staff estimate that the asset allocation tracking error will vary depending on the underweights in the policy asset classes to fund ARS. The tracking error is lowest if ARS is funded from cash and highest when funded from GE. Staff believes that funding from a mix of GE, GFI and Liquidity is more optimal from a risk/return basis than funding purely from GE.

Staff will report to the Committee the ARS percentage allocation and tracking error contribution to the Total Fund on a quarterly basis in the Risk Report to the Committee to monitor the allocation and risk impact.

An opinion letter from Wilshire Associates is attached. Wilshire has disagreed with the staff approach and believes that the “Total Fund Benchmark should contain an explicit 2.5% allocation to hedge funds.” Staff response to the Wilshire letter is as follows:

1. Staff does not propose to make ARS an “opportunistic position.” The ARS allocation has gradually increased from 0% to 2.2% of Total Fund with capital allocation decisions being made primarily within the GE group. Going forward, any new capital allocation must be approved by the staff Investment Strategy Group (ISG) and the CIO based on a risk/return analysis relative to other capital commitments. There is no intention to increase or decrease the allocation on a short-term opportunistic basis. Having an active allocation separate from the policy benchmark does not mean it is an “opportunistic” allocation.
2. ARS was not included in the 2010 Asset Allocation mix as a separate asset class. It was also not included in the policy benchmark for GE or Total Fund approved by the Committee. This was explicit in the Asset Allocation process and decisions.
3. Staff proposal ensures that the policy benchmark return is not altered, but staff takes the risk of relative performance due to ARS allocation. If it is the case that the underweight was from an asset class that has a return below ARS in any period, then it is additive to relative performance. If the underweighted asset class had a higher return than ARS, then it contributes to underperformance relative to the policy benchmark. This is an implementation risk that staff proposes to manage within a risk limit and an allocation limit which is contained in the ARS policy.
4. Including ARS in the GE benchmark distorts the approved policy portfolio and benchmark. The implementation portfolio can be different from the policy portfolio due to under or overweights of the policy asset classes as well as active positions in sectors and securities. In the staff proposal, the ARS allocation will represent such an active strategy managed within risk limits.

V. STRATEGIC PLAN:

This item addresses Strategic Plan Goals VIII, manage the risk and volatility of assets and liabilities to ensure sufficient funds are available, first, to pay benefits and second, to minimize and stabilize contributions; and IX, achieve long-term, sustainable, risk adjusted returns.

VI. RESULTS/COSTS:

Implementation costs of this item are expected to be minimal.

RAYMOND VENNER
Portfolio Manager
Asset Allocation

RICHARD ROTH
Senior Portfolio Manager
Risk Management

FAROUKI MAJEED
Senior Investment Officer
Asset Allocation/Risk Management

JANINE GUILLOT
Chief Operating Investment Officer

JOSEPH A. DEAR
Chief Investment Officer